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SUBJECT: ARGENTINE CENTRAL BANK PRESIDENT PLEAS FOR
PATIENCE WITH GRADUAL REFORM PROGRAM

Classified By: Charge d'Affaires Michael Matera. Reasons 1.4 (b,d)

Summary

11. (C) Argentine Central Bank (BCRA) President Martin Redrado urged patience with his sequencing of reforms during an October 20 meeting with Charge, claiming that a program of gradual monetary tightening was impacting inflation and some delay was warranted before Argentina returns to a fully floating exchange rate. In addition to solid monetary policy and the BCRA's comfortable reserve position, Redrado emphasized other positive economic developments: the GoA's strong fiscal balance, the strengthening financial system, and falling inflation, with the latter due mainly to sound macro policies, not price controls. Although he acknowledged that the primary fiscal surplus had declined 1% per year since 2003, Redrado argued there was no macroeconomic basis for spiraling inflation. On Paris Club, Redrado called for long-term rescheduling and clarified that the GoA would need to pass a law authorizing the BCRA to use reserves to pay arrears. Redrado reassured Charge that the GoA would submit draft counter-terrorism finance (CTF) legislation to Congress by year-end. End Summary.

Gradual Sequencing of Reforms is Critical

12. (C) Charge and Econoffs met with BCRA President Redrado

October 20 to discuss BCRA monetary and banking policies, inquire about his outlook on the broader economy, and get his assessment of the GoA's ability to submit a draft CTF law to Congress before the Financial Action Task Force's (FATF) February 2007 deadline.

¶3. (C) Meeting alone and speaking perfect English, Redrado asserted that Argentina's 2001/2 financial crisis was equivalent to the U.S. depression, especially with regards to its impact on the poor, and urged patience with Argentina's sequencing of reforms. He argued that Argentina must first complete the process of restructuring debt, ensure a healthy fiscal balance, rebuild the damaged financial sector, and accumulate adequate official reserves, before eventually implementing a fully free floating exchange rate regime and moving towards an inflation targeting monetary policy. Despite the country's impressive strides in these areas, with primary fiscal surpluses, a profitable and growing banking sector, and reserves topping \$28 billion (exceeding the level of reserves prior to the January 2006 payment to the IMF), Redrado called for restraint, noting that Chile took ten years to make a similar transition.

Gradual Tightening of Monetary Policy

¶4. (C) Redrado noted that real interest rates were now in positive territory as a result of his gradually contractive monetary policy. He claimed that BCRA rates on short term financial instruments (Lebacs and Nobacs) and repos (overnight lending) had almost doubled in the last year due to the BCRA's liquidity absorption policies. He admitted to generous monetary expansion in 2003 and 2004, claiming this policy was critical to the economy's recovery, but also

asserted that the contractionary impact of the last 18-24 months was measurable. Monetary expansion is currently half of what it was in 2005 and, consequently, real interest rates are now positive. (Note: yields on BCRA notes have been 11-12% over the last year, up from 6% in March 2005. End Note).

¶5. (C) Redrado refuted criticism of the BCRA's partial sterilization policy. BCRA intervention in the market has maintained the peso at an artificially low level, while allowing the BCRA to accumulate substantial official reserves. However, critics claim it will be difficult to continue sterilizing the BCRA's interventions while at the same time maintaining low interest rates. Redrado denied that this would be a problem, pointing out that no debt had matured at the last two auctions, so the BCRA was easily able to absorb 800 million pesos at each without bumping up Lebac and Nobac yields. The BCRA is also aggressively using repos to mop up excess liquidity. (Note: interestingly, repo rates have increased roughly 20% in 2006, possibly supporting critics' arguments. End Note). Redrado also dismissed concerns about the BCRA's quasi fiscal balance, which higher interest rates would jeopardize. He stated that the BCRA's profit in 2005 was 2.5 billion pesos, of which he used half to strengthen the bank's capitalization. He also claimed the BCRA's total net worth was \$7 billion, evidence of sound BCRA financial management.

¶6. (C) Redrado argued that the financial system has not recovered sufficiently for the BCRA to implement an inflation targeting regimen. In public statements, he has defended BCRA policy of relying on monetary targets to manage inflation, arguing that the speed of money circulation is less volatile than interest rates in Argentina, and the absence of a reference interest rate (i.e., federal funds rate) makes it more reasonable for the BCRA to use monetary targets.

Strengthening Banking System

¶7. (C) There have been two important and positive developments in the financial system, according to Redrado.

First, bank exposure to the public sector has fallen to 27% of total assets, from a high of over 50% in December 2002 and over 40% at the beginning of 2006. Redrado took partial credit for this, following his increase of capital requirements on public debt (which was zero percent during the 1990s). Redrado also credited lower GoA borrowing needs for the shift. For the first time in 13 years, credit to the private sector surpasses that to the public sector, "crowding-in" the private sector. The second development is the elimination of "mis-matched currency exposures on bank balance sheets," with bank assets and liabilities now both denominated in pesos and the BCRA serving as lender of last resort, in pesos.

¶8. (C) Redrado admitted that the lack of long term debt instruments in Argentina's still small financial market remains a concern, one that has led the life insurance companies and pension funds to invest billions in Brazil and

Asian market long term paper. (Note: banking sector credit to the private sector is only 10% of GDP, versus 35% in Brazil and 60% in Chile. End Note). Although the GoA has developed several lackluster initiatives, such as providing government support for the development of a secondary mortgage market (i.e., Fannie-Mae), these have gone nowhere. Redrado commented that the issue is whether the GoA or the financial sector will pay the up-front cost for developing a secondary mortgage market's risk-pooling infrastructure.

¶9. (C) As a longer term alternative, the BCRA is improving and adjusting bank regulation to increase banks' incentives to provide longer-term financing. In terms of bank supervision, Redrado stated that the BCRA's bank supervision department is already implementing Basel II risk standards, and the BCRA Directors' Board approved use of the Basel II "25 Core Principles" last month. Redrado's goal is to implement the Basel II "simplified standards" approach by ¶2010.

Inflation: Impact of Price Controls Overstated

¶10. (C) Redrado agreed that the primary fiscal surplus had eroded by one percent per year since 2003 due to increased public sector spending at the federal and provincial levels, and also acknowledged that this was pushing aggregate demand. Nevertheless, he argued that there was no current macroeconomic basis for spiraling inflation, given the BCRA's tightened monetary policy and the GoA's continuing primary fiscal surpluses of 3-4%.

¶11. (C) Redrado disputed that the GoA's price controls were the main factor in falling inflation, rather the BCRA's tightened monetary policies were having an impact. However, in a contradictory statement, he admitted that lower meat and dairy prices -- the result of price controls and export bans -- were responsible for a 2% decline in the 2006 inflation rate, compared to 2005. Redrado also admitted that these controls have created distortions and shortages, especially in the food and beverage markets. However, most areas are not as negatively affected, and he asserted that no businesses, in any sector of the economy, were losing money. He concluded by falling back on the oft-heard GoA complaint that the inefficient and semi-oligopolistic private sector was weak at anticipating and reacting to problems, and until the business class improved its competitiveness, government intervention was warranted.

¶12. (C) The price controls have had one positive affect, according to Redrado: taming salary demands. The major unions accepted 19% salary increases for 2006 and 11% for 2007, lower than expected because of the unions' faith in the GoA's ability to control inflation. While conceding that solid fiscal and monetary policies were the preferred means to maintain stable prices, he claimed that wage policy was also a key factor. (Note: in public statements over the last year, Redrado has defended BCRA policies, arguing that

inflationary pressures are due to expansive fiscal policy, salary hikes and supply bottlenecks in the manufacturing industry. End Note).

GoA Goal Should Be Long-Term Paris Club Rescheduling

¶13. (C) Redrado noted that the Argentine Congress would need to pass a new law to allow the BCRA to use reserves to pay Argentina's \$3.5 billion arrears to Paris Club creditor nations. The law authorizing the GoA to use official reserves to prepay Argentina's entire \$9.5 billion debt to the IMF in January 2006 only applied to debts to the International Financial Institutions. Regardless, Redrado argued that the GoA should pursue a long-term rescheduling agreement with the Paris Club that would not include a large upfront payment.

Draft CTF Law Will Reach Congress by Year-End

¶14. (C) Redrado stated that anti-money laundering and counter-terrorism finance (AML/CTF) were high priorities for the BCRA, and he is working with the Treasury Department to develop private-public mechanisms to improve AML/CTF coordination in the region. While Argentina has improved its AML legislation and enforcement, Redrado agreed that the top priority was to submit a draft CTF law to Congress prior to the February 2007 FATF plenary, as the repercussions of missing this FATF deadline could be devastating for the financial system. Redrado said the GoA's "Mixed Commission," comprised of law enforcement agencies, BCRA, and the Ministry of Justice, was working to complete a final draft by mid-November, and the Justice Minister had recently assured him that the goal was to deliver it to the President and then to Congress by year's end.

¶15. (C) Redrado said the Justice Minister's decision two months ago to take ownership of the drafting process had galvanized the GoA's effort. The Justice Ministry had since developed an adequate definition of "Terrorism" in the draft law that would exclude "social protest," and thus avoid a divisive human rights debate in Congress. Redrado admitted that the process had taken far too long, and had tarnished the GoA's reputation with other FATF countries, but emphasized that it was important to deliver a bill that met FATF standards and could also pass Congress.

Comment

¶16. (C) Redrado began his tenure as Central Bank President in late 2004 with low expectations from the community of Argentine economists, who considered him a relative lightweight. The central bank's steady performance to date has, however, won him increasing respect. While we appreciate his arguments for gradual reform, he must know that the current mix of BCRA and GoA policies is probably untenable in the medium to long run. The imposition of capital controls in 2005 has helped to alleviate upward pressure on the peso by diminishing short-term (portfolio) inflows and limiting the money supply expansion fed by the central bank's purchase of dollars in the FX market. Nevertheless, continued strong dollar inflows resulting from Argentina's high merchandise trade surplus will require ongoing BCRA intervention and will make it difficult for

Redrado to achieve his goal of restraining money supply growth and limiting inflation. End Comment.
MATERA